COMMITTEE ON GOVERNMENT REFORM

Subcommittee on Energy and Resources

DARRELL ISSA, CHAIRMAN

Oversight Hearing:

Royalty Relief and Price Thresholds III

July 27, 2006, 2:00pm
Rayburn House Office Building
Room 2154

BRIEFING MEMORANDUM

SUMMARY

This Subcommittee is investigating the absence of price thresholds in deepwater leases between the Interior Department and various oil and natural gas producing companies during 1998 and 1999. The Government Accountability Office estimates that the lack of price thresholds will cost the U.S. Government upwards of $10 billion in lost revenue over the life of the leases. According to GAO, this loss is estimated at nearly $2 billion to date.

Over the past five months, the Subcommittee staff has reviewed documents surrounding nearly every aspect of the lease creation process. This includes an examination of the regulations, leases, lease sale documentation, decision memoranda, and bureaucratic processes. Moreover, the Subcommittee staff has interviewed multiple witnesses, and Chairman Issa has conducted two oversight hearings at which individuals intimately familiar with the leasing process have supplied critical information.

The Subcommittee staff believes it has identified the Department employees who may have been responsible for the genesis of the problem, and who were in the best position to have done something about it. Milo Mason, a Department attorney, revealed himself in the June 21st hearing as the person responsible for dispensing arguably inadequate legal advice. Upon his advice, the Secretary of the Interior promulgated regulations that did not include price thresholds. Moreover, Mr. Mason found out in 1999 that the leases signed in 1998 and 1999 did not contain price thresholds, yet he failed to formally notify the Department in writing or take corrective measures.

The Subcommittee staff has since determined that information supplied by Chris Oynes, Gulf of Mexico Regional Director, appears to be inconsistent with other evidence obtained by the Subcommittee. Mr. Oynes, who signed 668 of the 1100 leases during 1998 and 1999, told Subcommittee staff during an interview that he did not know about the missing price thresholds until 2000. Chevron Corporation officials informed the Subcommittee that two of its employees notified Mr. Oynes and his staff of the missing price thresholds several times throughout 1998 and 1999. If the latter is true, Mr. Oynes and his staff could have saved the U.S. Government at least $5 billion had they immediately rectified the problem.

Accordingly, the purpose of the July 27th hearing is to question Mr. Oynes, his Deputy, and the two Chevron employees who maintain they notified the Department of the problematic leases. Mr. Oynes signed 668 deepwater leases during 1998 and 1999 and was in the best position to know of the problem and take corrective measures. Alas, the American people are now unnecessarily burdened with this unprecedented $10 billion loss.

BACKGROUND

The Deep Water Royalty Relief Act

To appreciate the magnitude of this blunder, it is useful to understand the policy behind the Deep Water Royalty Relief Act and what Congress sought to accomplish. In 1995, Congress enacted the Deep Water Royalty Relief Act[1] (the "Act") to provide financial incentives to oil and gas companies to explore and extract oil and natural gas from our deep coastal waters. This came at a time when oil and natural gas prices were low and the interest in deepwater drilling was lacking. The Act – tirelessly lobbied for by Democratic Senator J. Bennett Johnston of Louisiana and enacted by a Republican Congress – provided a mechanism by which the Secretary of the Interior and oil and gas companies were to enter into leases of federal waters. Furthermore, the Act provided the critical royalty relief terms these leases were to include.

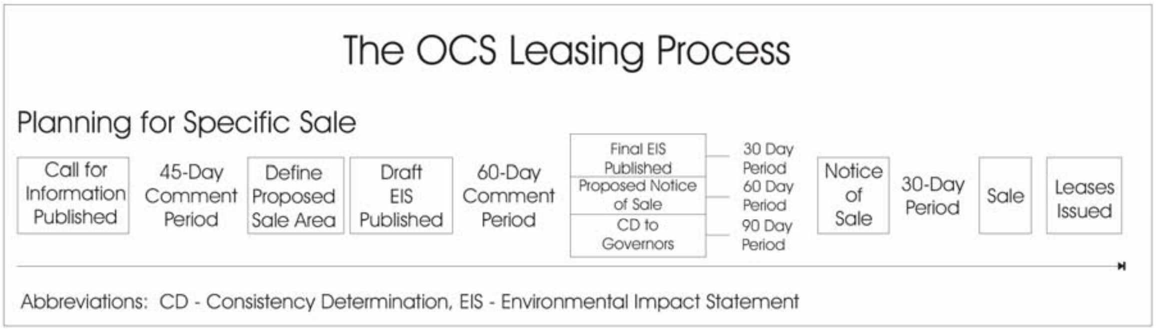
Effective November 28, 1995, companies with eligible leases would be allowed to operate royalty-free until either a certain volume of production was achieved, or the market price for oil or gas reached a specified ceiling. Upon the occurrence of either event, companies would begin paying royalties to the U.S. government at an agreed-upon percentage rate. These lease terms, also known as volume suspensions and price thresholds[2], became critical components of thousands of leases entered into between 1995 and 2005. To begin leasing property under the Act, however, it was first necessary for the Department to promulgate a rule delineating the process by which it would award leases and grant royalty relief.

Given the immediacy of the Act's effective period, the Department published an interim rule on March 25, 1996. This interim rule contained, among other things, a bidding

[1] 43 U.S.C. 1337 (1995)
[2] The implementation of volume suspensions was mandatory, whereas price thresholds were discretionary.

system and a royalty relief scheme for eligible leases. Throughout 1996 and 1997, hundreds of leases were entered into pursuant to the guidelines set forth by this interim rule. It was not until January 16, 1998 that the Department issued a final rule. For the remainder of the effective period (1998 through 2000), leases were then entered into pursuant to the final rule.

The OCS Leasing Process



The leasing process is quite involved and occurs over a period of approximately one year. After a lengthy planning stage that includes multiple studies and numerous reviews, the Department advertises in the Federal Register a particular area that it intends to lease. This advertisement, otherwise known as a "final notice of sale," includes the terms and conditions of the lease sale. (These terms include, among other things, a description of the land and royalty relief provisions applicable to qualifying leases.) The Department then enters a bidding phase, wherein multiple companies compete for the right to lease and drill on the land described in the notice. Successful bids are awarded leases. These leases include the terms and conditions described in the final notice of sale and are governed by statute and Departmental regulations. This process, which appears remarkably simple on its face, requires a tremendous amount of legal and bureaucratic oversight within the Department.

At nearly every turn, there are decision memoranda passed among multiple levels of management for their review and approval. This is true not only for the leasing process, but also for the drafting and promulgation of the regulations. All told, there are nearly thirty surnames required for every lease sale, including those of every supervising and reviewing attorney in the Solicitor's Office[3]. Incidentally, most of the attorneys who reviewed and signed off on the interim and final regulations, the final notices of sale, and numerous decision memoranda, are employed by the Department's Solicitor's Office to this day. Furthermore, the Department official who signed hundreds of problematic deepwater leases during 1998 and 1999 – and who allegedly was aware of the lack of price thresholds – remains intimately involved with the leasing process.

[3] A "surname" is a signature that indicates an approval of the contents of the document on which it appears. See Attachment 2, a spreadsheet furnished by the Interior Department which contains a list of every name and title of those individuals involved in the lease sale review and approval.

THE PROBLEM

The United States Government faces an enormous problem at the hands of the Interior Department. Neither the regulations promulgated by the Department, nor the leases entered into during 1998 and 1999, contained the critical price threshold provisions contained in leases signed in 1996, 1997, and 2000. (In 1996, 1997, and 2000, price thresholds and volume suspensions were included in addenda to the lease documents because the interim regulation failed to impose price thresholds. In 1998 and 1999, the Department discontinued the practice of detailing royalty provisions in addenda.) Consequently, companies that signed leases eligible for royalty relief in 1998 and 1999 are able to sell oil and gas at fair market value until they produce the amount permissible under the volume suspension scheme. In 1998 and 1999, fair market value of a barrel of oil was well under $20. Today, it is nearly $74. For natural gas, in 1998 and 1999, the price per thousand cubic feet was about $2. Last year it averaged $7.51. This means that in a field greater than 800 meters depth, lessees are producing and selling millions of barrels of oil and trillions of cubic feet of natural gas at today's market price royalty-free until volume suspensions expire. As a result, these companies are not surrendering billions in royalties owed to the American people.

Accordingly, the purpose of this investigation is to determine why price thresholds do not appear in leases entered into during 1998 and 1999, and identify those individuals who either caused the error or who were in the best position to rectify the problem and failed to do so. Moreover, an ancillary objective is to identify and pursue whatever measures are necessary to remedy this error. The Subcommittee has nearly accomplished all three objectives.

HISTORY OF THE INVESTIGATION

The Subcommittee became aware of this problem by way of a *New York Times* article published in late January of 2006. The Subcommittee subsequently engaged in an aggressive oversight investigation into the allegations in that article. The investigation began with a hearing on March 1, 2006, and has thus far culminated in witness interviews, an intense document review, and a June 21st hearing at which oil company executives and Interior Department officials testified. Through these efforts, the Subcommittee has identified the individuals responsible for the creation and perpetuation of the faulty leases.

RECENT FINDINGS

The Subcommittee staff believes it has identified the Department employees who may have been responsible for the genesis of the problem, and who were in the best position to have done something about it. At the June 21st hearing, Milo Mason unveiled himself as the Interior Department attorney responsible for the promulgation of faulty regulations. He testified that upon his legal advice, the Department implemented the Deep Water Royalty Relief Act with rules that failed to impose price thresholds. As a result, over a thousand deepwater leases did not contain price thresholds. The lack of price thresholds in these leases allows companies to sell oil and natural gas at record-high market prices without paying billions in royalties. He ultimately could not account for his actions.

Mr. Mason was cavalier in his responses to Chairman Issa's prodding, and was ultimately unable to substantiate his flawed legal reasoning. When asked, he replied that "it didn't seem like as big a deal as it is now, for sure, at that time." He also remarked that in 1999, he was aware that the leases were faulty, yet failed to either correct or adequately document the problem. Instead, he noted that his practice is not to write memoranda or keep a chronological file[4] because his desk drawer is full. He ultimately agreed with Chairman Issa, however, that there would be no investigation today had he advised the Department to include price thresholds in the regulations implementing the Act.

But even more explosive than Mr. Mason's testimony was that of a Chevron Corporation official. Government Reform Committee Chairman Tom Davis signed five subpoenas to compel the testimony of oil executives after they declined our invitation to testify. (Though four of the companies begrudgingly agreed to testify under threat of subpoena, Shell Corporation continually refused and its president, John Hoffmeister, was served.) The purpose of eliciting industry testimony was to determine the extent of its interaction with the Department regarding the faulty leases. We believed that industry must have contacted the Department when it noticed that price thresholds were no longer included in 1998 and 1999 leases as they were in 1996 and 1997. We were right.

According to a Chevron official's testimony, Chevron employees met with Department officials in 1998 concerning the missing price thresholds in deepwater leases. At Chairman Issa's request, Chevron detailed in follow-up correspondence how two of its employees had three meetings with Chris Oynes, Director of the Gulf of Mexico Region, to discuss the problematic leases. These discussions occurred over the course of three quarterly meetings between members of the American Association of Professional Landmen's Outer Continental Shelf Committee[5] and Mr. Oynes and his staff during 1998 and 1999.

The general purpose of these quarterly meetings was to discuss various issues related to the Minerals Management Service's ("MMS") administration of offshore oil and gas leasing. According to Chevron officials, two Chevron employees informed Mr. Oynes and his staff on three separate occasions that price thresholds were imposed neither through the regulations nor in addenda to 1998 and 1999 leases. Mr. Oynes first replied that the price thresholds were contained in the 1998 regulation, but when subsequently informed by the Chevron employees that they were not, he indicated that he would have his staff review the issue. It is now clear that Mr. Oynes and his staff failed to take corrective measures despite allegedly being notified on three separate occasions that the leases did not contain price thresholds. The result of his inaction is now manifest.

[4] A record of legal advice given to Department officials.

[5] The AAPL OCS Committee, during 1998 and 1999, was comprised of representatives from most of the major oil and gas producing companies that held deepwater leases including Exxon, Mobil, Texaco, Phillips, et al.

The Subcommittee will examine whether Mr. Oynes has sought to obstruct this Congressional investigation and to mislead the Subcommittee staff. In May of this year, the Subcommittee staff interviewed him about his knowledge of the missing price thresholds. When asked specifically about when he became aware of the faulty leases, he professed not to know until 2000. This conflicts with the information supplied by Chevron officials. The Subcommittee will examine in a public hearing, and under oath, whether Chevron officials are telling the truth or Mr. Oynes is lying. If Mr. Oynes had been notified, and had he taken corrective measures when he was notified, he could have prevented at least $5 billion in lost revenue.

CONCLUSION

The American people have been shortchanged by negligent Interior Department officials. Some of these Department officials, who today remain employed in their same capacities, are responsible for a nearly $10 billion loss of revenue generated from our outer continental shelf. Had they taken measures to correct this mistake when they were notified, they could have saved at least $5 billion.

WITNESSES

Panel 1:

- J. Keith Couvillion, Deepwater Land Manager, Chevron North America Exploration and Production Company, a Division of Chevron U.S.A., Inc.
- Gordon R. Cain, Deepwater Land Manager, Chevron North America Exploration and Production Company, a Division of Chevron U.S.A., Inc.; and

Panel 2:

- Chris Oynes, Regional Director, Gulf of Mexico, Minerals Management Service; and
- Charles Shoennagel, Deputy Regional Director, Gulf of Mexico, Minerals Management Service.